State Investment Commission
Monthly Meeting Minutes
Wednesday, September 24, 2014
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:06 a.m., Wednesday, September 24 2014 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, Ms. Faith LaSalle, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Frank Karpinski, and General Treasurer Gina Raimondo. Mr. Andrew Reilly was absent.

Also in attendance: Mr. Larry Brown, Mr. Darren Lopes and Mr. David Iden of TIAA-CREF, defined contribution plan administrator; Mr. Thomas Lynch and Mr. Steve Nesbitt of Cliffwater, alternative investment consultant; Mr. John Burns, Ms. Judy Chambers and Mr. Alan Emkin of Pension Consulting Alliance (PCA), general consultant; Ms. Sally Dowling and Mr. John Lerner of Adler Pollock & Sheehan P.C., legal counsel; Ms. Maryfrances Metrick and William Rahm of Centerbridge Capital; Mr. Ron Mika of Sorenson Capital; Ms. Anne-Marie Fink, chief investment officer, employees and members of UniteHere, and members of the Senate Fiscal and Treasurer's staff.

II. Approval of Minutes

On a motion by Mr. Costello and seconded by Mr. Giudici, it was unanimously

VOTED: to approve the draft of the minutes of the July 23, 2014 meeting of the State Investment Commission.

III. Defined Contribution Plan—Quarterly Update

Mr. Lopes reviewed the plan through August 31, 2014. As of that date, the plan had $295 million in assets. He said the plan is growing very quickly. He reviewed the participant count. He said TIAA-CREF continues to have one-on-one conversations with participants as they see more traction in the plan. He gave an overview of the assets by fund and what they look like segmented by various age groups.

He gave an overview of employee engagement. In comparison to 2013, the number of interactions in 2014 has started to drop because the market has been doing so well. One-on-one meetings have also started to decrease. To date, they have engaged about 35% of the 32,000 participants in the plan either on the phone or one-on-one. They're trying to continue to go on-site but need the board's help in those efforts.

IV. FARP Investment Options Recommendation

Ms. Fink reminded the board that FICA Alternative Retirement Plan (FARP) is for seasonal and part-time employees. The role of the SIC, as set out in the statute, is to "review and evaluate the reasonableness of the selected financial institution's fees and the performance of the selected financial institution's funds."

Mr. Lopes reviewed the plan. Through August 31, 2014 the plan has $251,000 in assets. The average account balance is about $298 per participant. He noted that the plan has access to the collective investment trust at 0.11%, which is rare for a plan this size.
He reviewed the demographics. The bulk of the participants are under 25 years old. The plan has been in operation since July 1, 2013.
Mr. Mullaney went on to review the fees of the plan. The fees are $45 per participant per year. The state is paying $13 per year, so the employees pay $32 per year, which is the same as what the state employees are paying in the defined contribution plan.
Ms. Fink also added that the fees at the fund level are much lower than what balances this size could get on their own.
Ms. Reback asked the Treasurer to submit legislation to repeal this statute or ask for the State to make a contribution as these employers have low pay.
Treasurer Raimondo said that the General Assembly had passed this bill and it would be up to the Retirement Board to submit any such motion. In the meantime, the duty of the SIC is to review the fees and the investment options as per statute.
Treasurer Raimondo also said that she and the SIC would encourage the Retirement Board to advocate repeal of the FARP legislation the General Assembly passed last session.
Mr. Brown reviewed the performance of the plan. Year to date through 8/31/14, the plan is in line with all relative benchmarks.
He said there are two changes forthcoming. The Vanguard 500 index fund is currently in the Signal share class and will move into the Institutional share class that will lower the expense ratio by 0.01%. The Signal share classes will change their name from Signal to Admiral but it's a change in the name only, not to the strategy or the fee structure.
He reviewed the peer-group rankings.

V. Private Equity Recommendations—Sorenson Capital Partners III & Centerbridge Capital Partners III

Mr. Mika gave a brief overview of Sorenson Capital Partners and their strategy. They target investments in the small end of the buyout market and in growth equity. They have a principal investment culture with a deep team. He then gave an overview of their team members.
Mr. Mika reviewed the Mountain West region. It's a vast geography. The GDP of those states combined is about a third that of California's so they have to be out in marketplace covering theses states. He also reviewed a chart indicating how under-penetrated private equity is in their core states.
Mr. Mika left the room.
Mr. Lynch said this recommendation helps the overall private equity program to maintain the 7% strategic target. The plan for the next year is to do $175 million to $200 million in commitments. Currently the State has made about $110 million in commitments into 5 funds, for vintage year 2014. The portfolio has been underweight in the small end of the buyout market. He said 7% of the private equity portfolio is in small and buyout funds. He said they would want to increase it and get to about 10%. This fund meets that strategy. He added that large-cap markets are competitive in the private equity market. This firm's strategy does well in its market because they can access proprietary deals and create value after their investment. He said Cliffwater recommends a $30 million commitment.
The board discussed the recommendation.

On a motion by Mr. Fay and seconded by Mr. Mullaney, it was unanimously
VOTED: to approve a $30 million commitment into Sorenson Capital Partners III.

Mr. Lynch introduced Centerbridge Capital Partners. He said ERSRI is already invested with Centerbridge in two previous funds. They have a value approach to investing that will serve them well in a competitive environment for deals.

Mr. Rahm gave a brief overview of the firm. They have one team that invests across two strategies in multiple sectors with offices in New York and London.

Ms. Metrick reviewed their strategies. She said having different strategies gives them a competitive edge. They acquire companies by buying the debt or the equity depending on the economic environment and where value can be found.

Ms. Metrick reviewed the returns on their previous funds. She gave an overview of companies where they gained control and made a difference in their performance. The first fund was mostly invested in North America but has a lot of diversity in terms of industry. She said 75% of the capital has been fully or materially realized. Returns on that fund are 31% gross IRR and a 23% net IRR. Their second fund is still being invested. She added that 73% of that fund is invested as of June, 30 2014. So far they have received returns of 1.2 times invested capital.

She reviewed the terms of the third fund. The fee structure is 1.5% on committed capital during the investment period and 1.25% on invested capital thereafter. She said the focus of the fund will remain predominantly on US and Europe. The fund is capped $5.75 billion plus limited partner capital.

Centerbridge left the room.

Mr. Lynch noted that this fund is a portfolio fit; its middle market transactions are a bit underweighted in the portfolio. In today's market where things are very competitive, this is very value-oriented investment approach. Centerbridge is very disciplined about the prices they're paying. Cliffwater recommended a commitment of $30 million.

Ms. Fink noted that the firm's strategy is attractive because they have a full suite of options regardless of the business cycle. She believes they will find different opportunities and be able to generate value more than the average big buyout fund.

On a motion by Mr. Costello and seconded by Mr. Mullaney, it was unanimously

VOTED: to approve a $30 million commitment in Centerbridge Capital Partners III.

VI. General Consultant Review

Mr. Emkin reviewed Pension Consulting Alliance's current relationship with ERSRI. PCA has been working with ERSRI since 2008. They are the general consultant and also provide real estate consulting. They consult on investment policy, comment on investment managers, and deal with investment policy issues, strategy and structure.

He reviewed the areas in which they assist the State. Their goal is to provide Rhode Island with an independent source of what is happening in capital markets and among peers. Last year, PCA worked with Rhode Island to revitalize the real estate portfolio.

Almost all their clients are large public pension plans. He said their business is designed to be conflict-free. Therefore, they do no asset management or brokerage. They believe each plan is unique and strategies and advice should be equally unique.

He reviewed some of their clients. He said they currently have over $1 trillion worth of assets under advisement.

He then reviewed their organizational structure and personnel. The Board asked questions.

Treasurer Raimondo noted that she is pleased with the work PCA has done.

Ms. Fink added that they talked to a few other competitors of PCA and they are very comfortable with what they do. She stated that having a group that is a bit more agnostic across the asset classes is very valuable.

VII. Review of Long Term Returns

Mr. Nesbitt reported on his study of the status of statewide pension systems, from an asset and performance point of view.

He said the study is strictly of state-wide pension systems over a ten-year period. There are approximately 95 state-wide pension systems. Most of the information obtained from these pension systems are from the Comprehensive Annual Financial Reports (CAFRs) that is required from each plan.

He reviewed the performance of 66 systems that have the same fiscal year. He said one limitation of the study is that the reporting of returns by pension systems is inconsistent, particularly as to whether the returns include fees or not. About 1/3 of state systems say they report net of fees. Another 1/3 say they report gross of fees and the remaining 1/3 don't disclose whether performance is gross or net.

Mr. Nesbitt also noted that the study did not include risk as every state's situation is different.

Ms. Fink quoted data from a Standard & Poors report based on 2012 CAFR data comparing ERSRI and the California pension system. California is 72% funded compared to Rhode Island's58%. As a result they might have more risk tolerance. The study also looked at the unfunded accrued actuarial liability, which is a good measure of how able a state might be to fund a shortfall. ERSRI ratio's is 8.5% and for California the number was 4.6%. California's lower liability is a good indicator for why California might be able to take on more risk than Rhode Island.

Mr. Nesbitt went on to review the returns in the study. He said that over the ten-year period ending June 2013, the median state pension returned 7.2%. He noted that most state pension funds have an actuarial rate of 8%. He said the range of returns was from 5% to 8.8%. The average was about 7.2% compound annual return. A simple 60/40 portfolio would have returned 6.4% over this same period. All the work state systems have done investing in alternatives contributed to overall performance. Collectively, state systems have added value through the efforts of staff, advisors and managers over this period.

He reviewed RI's experience against these metrics. Rhode Island's return over this period is 7.4% net of fees. Rhode Island outperformed the 7.2% average reported for the ten-year period. He noted the ranking is understated as Rhode Island numbers include all fees whereas many other state plans do not.

Mr. Costello asked if the fees could be estimated and Mr. Nesbitt said they couldn't be. A major contributor was private equity. Generally, those state systems that have had meaningful allocations to private equity have outperformed over long periods of time, as have foundations and endowments, which also have greater alternatives allocations.

Mr. Nesbitt reviewed the fees of the five states that release full fee information. Rhode Island ranked in the middle. Mr. Costello noted that the fund with highest fees also had the best long-term returns.

In reviewing allocations, Mr. Nesbitt said Rhode Island's allocation to alternatives at June 30, 2013 was about 26%. This is in line with the 25% average among other state pension funds.

Ms. McNamara asked if the fact that endowments have a much smaller pay-out obligation correlates to their better performance.

Mr. Nesbitt said yes. Endowments don't have a fixed liability like state plans do. When assets fell in 2008, many endowments reduced benefit payouts. State plans don't have the luxury of reducing benefits when assets fall.

He said there are 18 state funds that have hedge fund allocations above 10% of assets. Those funds have done well over the last ten years.

He said that most state funds outperformed the 60/40 portfolio and only a few funds outperformed the average actuarial rate of 8% for that period. He noted the ten year period was a good period to study performance because it included bear and bull markets.

He noted ERSRI has done a great job of measuring and reporting fees, which is a task that most state pension systems basically ignore. Most of those that do report fees only do partial reporting.

Treasurer Raimondo asked if any other pension fund is as transparent in fees as Rhode Island.
Mr. Lynch said the only other fund they have found that is as transparent is the Missouri Employees' pension plan.
Mr. Nesbitt reviewed asset allocation trends among state pension systems. He said plans have mostly moved out of equity in an effort to manage risk.
A number of states are endowment-like in their allocation. States at the bottom of performance rankings have very low, if any, allocation to alternatives. Some states have statutory limitations preventing them from investing in alternatives.

VIII. Short-Term Cash Investment Policy Recommendation

Mr. Vin Izzo, the state's cash manager, reviewed the proposed short-term investment policy. He said the last time the policy was formally revised was in 2009. Changes since then have been incorporated into the current policy.
He said the policy is structured differently from that of the pension fund. Everything is done to manage operating funds so they cannot take any losses. One of the changes in the revised policy recommended is to give further diversification options. He asked the Board to remove the restriction on the use of commercial paper.
Ms. Fink noted a few other changes to the policy. One is that the policy previously required AAA-rated banks. There are no AAA banks currently and the policy was updated to cite AA rating requirements. Also, on the brokerage side, the previous policy required only $2.5 million in capital for a broker. That was changed to $250 million in capital.

On a motion by Ms. Reback and seconded by Ms. McNamara, it was unanimously
VOTED: to approve the updated version of the short-term investment policy.

IX. Master Limited Partnership Briefing

Ms. Fink said the state is relatively new to infrastructure. There are two forms of infrastructure: private and publicly traded. The state made an allocation to private infrastructure with IFM and is looking to bring in a few more funds. The other area where the policy target has an allocation is to master limited partnerships (MLPs), which are a form of publicly traded infrastructure.
Ms. Chambers explained that a Master Limited Partnership is a publicly traded partnership that owns and operates energy and natural resource assets and projects. The key characteristics of the asset class are that they generate significant cash flow and pay out quarterly dividends to investors.
She gave an overview of the partnership structure.
She said MLPs have performed very well after the global financial crisis. Their annualized returns look good in the last five years, but MLPs were down 36.9% when the markets were down 37% in 2008. Because of their market beta, if the markets turn MLPs most likely will also have a large downturn.
Treasurer Raimondo asked how big the MLP space is in today's market.
Ms. Chambers said currently there are about 117 MLPs in the public market with about $600 billion in value. In 2009, there were 66 MLPs in the market worth about $160 billion. She doesn't foresee a lot more coming into the marketplace. She does see institutional investors starting to put more money in the asset class.
She then gave an update on the RFP done in August. The RFP was for potentially investing up to $160 million into MLPs. The RFP received 27 responses. In the first round PCA and staff narrowed the pool of contenders from 27 to 11 managers. In the second round they have identified five short-listed managers. They will have conference calls with the finalists and then hopefully do on-site visits to two to three. She said they would potentially bring a manager before the Board in the October meeting.

Ms. Fink added that the fact that they're moving toward recommending a manager does not oblige the SIC to put the money to work. Part of the purpose of this briefing was to get feedback from the Board.
Mr. Costello noted that the Board should be careful making such decisions around the time when a new treasurer will be transitioning in. He also expressed some concern over the asset class, its pricing after a strong run-up, and its risks.
Ms. Fink suggested moving slowly and bringing a manager to approve in November and no investment decision until February or January.

X. Legal Counsel Report

There was no legal counsel report.

XI. CIO Report

Ms. Fink reviewed the returns for July and August. In July US equity markets fell almost 2%, global equities dropped 1.2% and bonds lost 0.25%. In this environment, the portfolio with its risk-controlled approach outperformed. The portfolio was down 0.7% compared to -0.9% for the bottom-up benchmark and -0.8% for the 60/40 basic allocation. Alternatives led the outperformance, with hedge funds down 0.5%, private equity up 1% and real estate positive 1.2%. Risk remained at 7.3% which is well below the benchmark's risk at 7.9% and the 60/40's at 8.4%. The risk-controlled approach generated better returns in tougher markets.
August performance was the opposite of July's, as sentiment turned more positive with the Fed remaining accommodative. US equity markets rose 4%, global equities were up 2.25% and fixed income rallied with Barclays aggregate up 1.1%. She noted that usually fixed income and equities move in the opposite directions giving correlation benefits. She believes it will be somewhat challenging to find things that can give diversification benefits going forward. For August the portfolio was up 1.55% ahead of the benchmark and a bit behind the 60/40. The portfolio had 7% risk compared the benchmark at 7.5% and the 60/40 at 8%. She said equities, private equity and core fixed income were the best performers in the month.
Ms. Fink told the Board that Brown Brothers Harriman received a fine of $120,000 from the SEC for filing required forms late. They also received a fine from FINRA related to careless procedures of anti-money laundering. In both cases she, PCA and the SEC have attributed the shortfall to oversights rather than manipulative intent. Brown Brothers Harriman has increased their compliance staff by 57% and has instituted more rigorous procedures to avoid these mistakes. Therefore, she is not recommending any changes.
She said she and staff are currently working on two RFPs. One is the MLP RFP and the other is for a 529 investment consultant. She said the 529 investment consultant RFP is in its final stages and she expects to bring a recommendation to the October meeting.
Considering recent news of the California pension fund exiting hedge funds, she asked Cliffwater to do an analysis on the liquidity of the ERSRI hedge fund portfolio. She said questions have been raised about whether there will be a run on hedge fund as a result of the Californians exit. She noted hedge funds are still very much a vibrant asset class. In the last quarter of 2014, $30.5 billion went into the asset class and there is no evidence of a large wave of exits. To the extent there is a run on hedge funds, the concern would be with the liquidity of the assets that hedge funds own. She asked Cliffwater to tell us what the exposure is to the different levels of liquidity.
Mr. Lynch reviewed the hedge fund portfolio in terms of liquidity. He said 6.6% of the portfolio is in Level 3 assets, which have the least liquidity. The portfolio has limited exposure to illiquid assets. If there were to be a run on hedge funds, he would not expect to see any problem with liquidity due to underlying securities in the portfolio.

XII. Treasurer Report

Treasurer Raimondo thanked the Board and commended them for their continued work. There being no other business to come before the Board, on a motion by Ms. Reback and seconded by Mr. Fay the meeting adjourned at 11:55 a.m.

Respectfully submitted,

Gina M. Raimondo
General Treasurer